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Taper Tantrum 2.0 fears rattle markets

The unnerving start to the year escalated last week, with many lay observers attributing market volatility to the rising possibility of war between Russia and Ukraine. But, as outlined in the video market update we posted last Wednesday, while political tensions are not helping markets (nor energy prices), the heart of the market rout lays with the re-emerging determination of central banks to fight inflation through monetary tightening. Markets are concerned central bankers, namely the US Federal Reserve (Fed) have veered from downplaying the inflation threat to overreacting, particularly now, when the economic temperature is coming back down on its own (more about this later).

Readers may feel reminded of the market dynamics of the 2013 'Taper Tantrum', when equity markets sold off markedly after the Fed announced its intentions to wind-down its quantitative easing (QE) policy by reducing the pace of US Treasury purchases – indicating the beginning of a monetary tightening cycle. Back then, the news caused a 'tantum' from bondholders, pushing up bond yields significantly, while equity markets recovered relatively quickly. If history repeats itself, it would therefore seem that the current bout of market volatility is nothing overtly unusual at this stage of the economic cycle, and unlikely to herald a poor year for investors after two surprisingly strong ones.

While this is broadly true, and our central case circumstances are, of course, never quite the same. We are in near-uncharted territory (a post-pandemic recovery period), while it is also worth noting central banks have not entered a tightening cycle with the expressed intention of bringing down inflation since the 1990s (more recent tightening has been aimed at preventing inflation from reaching the levels they are already at today, and about central banks raising rates to re-establish rate cutting potential to fight later downturns).

Markets are, therefore, excused for being both jittery but uncertain over the most likely direction of travel, as last week's wild swings evidenced. This drab and second COVID-restrained January certainly does focus minds on the negatives. Retail investors are understandably worried about preserving the gains made over the past two years, even if they never really quite understood the reasons behind those gains, given the global economy – and their life in general – never lived up to a similar level of positivity.

That there were almost as many buyers as sellers of risk assets last week points to certain cohorts of investors being willing to identify positives further ahead, and also willing to assume the Fed will resist being too single-minded in its inflation fight to inadvertently choke off the nascent recovery. We remain in pandemic times, but we are quite evidently approaching the point of exit. Those who disagree will nevertheless have to admit that, even at the height of the pandemic, springtime has always brought relief and a significant rebound of economic activity.

So we wanted to share our thoughts and observations on the many moving parts that will appear to confuse, unnerve, but also present opportunities for the investment community, as we look beyond the dark days of January 2022.

As discussed, last week has seen the current major worries become more prominent in investors' perception, with negative impacts – real or potential – dominating. We list some of them below (in no particular order), and with a rough assessment of the direction of travel. The assessment of 'Now' is where we were at the end of last week, relative to recent past. It is not meant to tell us whether markets will go up or down, nor does it give each of the worries their own weightings. Rather, it places the different parameters driving investor concern into a loose context and helps gauge overall risk appetite.

The number of items on the 'worry list' have not increased, which is a mild positive. If the list grows, one would expect that in itself would hurt risk appetite.

Worry... rising or falling?	↗	means rising fear
	Now	Later
Pandemic	↘	↘
Inflation	→	↘
Fed policy error	↗	→
US fiscal policy	↗	↗
China policy error	↘	→
Russia confrontation	→	↗
Energy	↗	↗
Sum of fears	↗	→

Source: Tatton IM

The start of last week was dominated by heightened tensions with Russia over the Ukraine. After the removal of diplomatic support staff and families from Kyiv, the temperature appears to have cooled a smidgeon. Nobody thinks we are out of the woods, though. The experts of the Scowcroft Institute (based in the US, the experts being past senior soldiers) were somewhat pessimistic given the continued build-up of Russian forces in Belarus (which is much closer to Kyiv than Russia). They did say that the Russians would gain most advantage by moving swiftly. Moving heavy forces across March's thawing ground would be difficult, so the risk is likely to lessen with time.

Still, it is difficult for Europe and the US to give Putin what he wants while maintaining public support. This political dynamic feeds into energy prices, especially Europe's natural gas prices. Interestingly, these remained stable last week. However, oil prices peaked on Wednesday. Supplies from oil refineries are being hampered by outages and market conditions, and with relatively low stockpiles around the world, there is only a limited cushion to absorb market shocks.

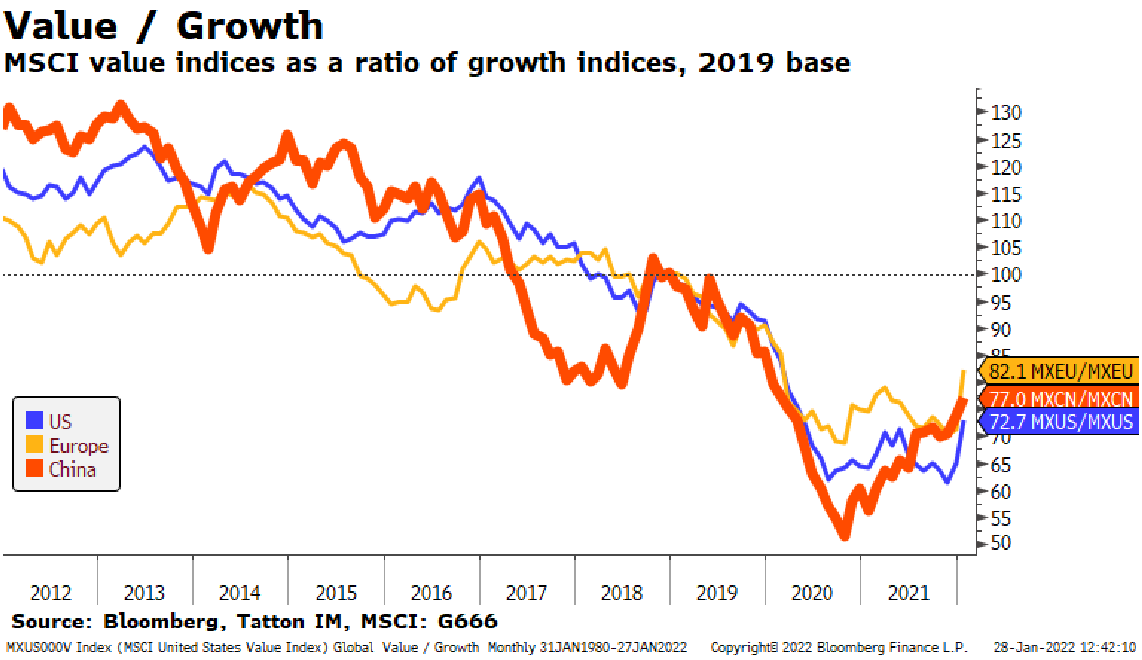
Overall oil production has been ramping up slower than expected in both OPEC+ countries and in the US, despite the longer-term oil price hitting over $60 per barrel. The climate change barriers to investment in high carbon emission fuel is being blamed. The argument goes thus; if the timescale for productive life is halved, the crude price needs to be double the previous level for the investment to make sense. And, as we head towards the 2050 climate change 'deadline for humanity', things will get worse before sustainable sources are viable.

This only highlights the climate change conundrum. Meanwhile, global oil prices could also be affected by US President Joe Biden's slump in the opinion polls. Republicans still appear likely to win back control of both the Senate and Congress, and are on course for the Presidency in 2024, even if the smart money is on Florida Governor Ron DeSantis, not Donald Trump. Biden wants to get his environmental measures through in a bill which may arrive in April, but which may prove too difficult to pass. In a more Republican-dominated environment, we might well find US shale and other oil producers are happier to invest.

We look at two of the other factors on the risk list in this week's other articles. Both the US and China are areas where investors worry about policy-induced risks. Last week, the respective authorities gave us much to consider. The Federal Open Market Committee (FOMC) left rates unchanged, but reiterated messaging from December that it sees little reason not to tighten monetary conditions substantially from March. Following Fed Chair Jerome Powell's press conference, equities wobbled but did not fall through the week's lows.

Trading volumes in risk assets have risen amid a week of relative consolidation. At the risk of rationalising what is difficult to prove, it looks like ownership is passing from retail investors to institutional investors, with the retail investor favourites remaining under pressure. This might be said to include cryptocurrencies, with Bitcoin (once again) having more than halved in value over the last two months.

Meanwhile, stocks displaying 'value' characteristics have continued to outperform, as the chart below shows. One might associate this with a market that is positive on economic growth. In the US, it may be a near-term signal of the opposite should retail investors find their spending power curtailed by declines in their portfolios of short-term investments.



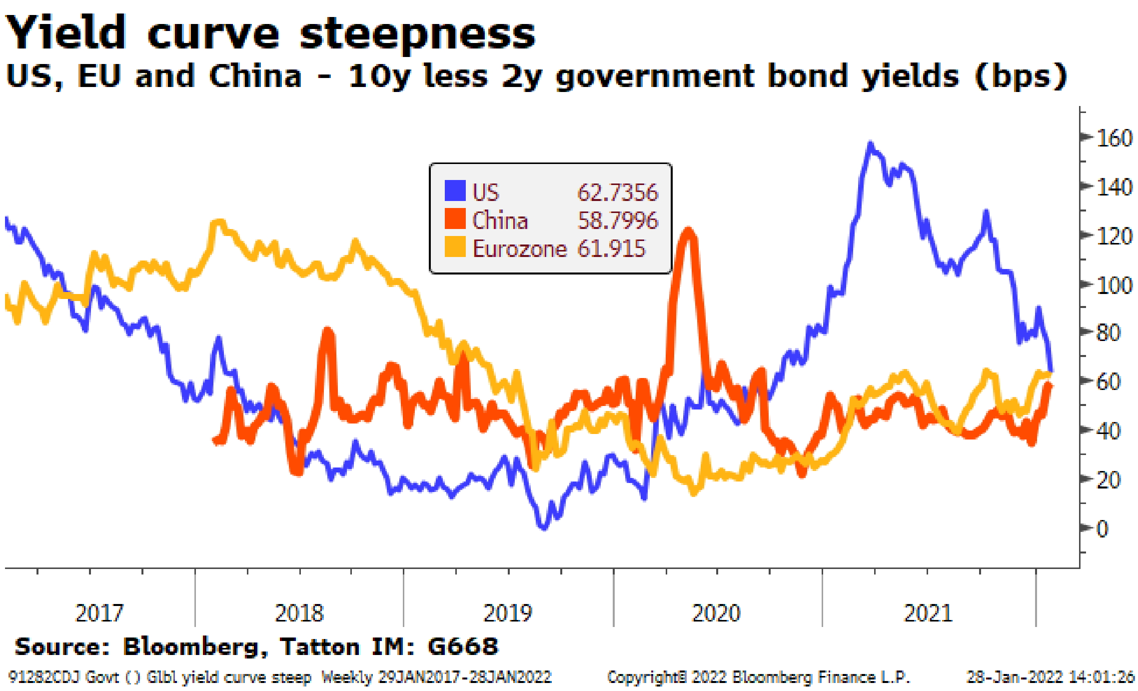
That's corroborated, to some degree, by the other growth signal many market observers watch: the steepness of yield curves. A steepening yield curve is usually associated with a rising likelihood of growth. That's being indicated in Europe and China, but the US is showing the opposite in the chart below.

We write about China in our third article. Last week saw a significant step-up in policy actions, all focused on addressing the extreme compression of assets linked to Chinese property developers (with Evergrande at the forefront). Interest rates have been cut, developers have been underpinned, and state-governed investment institutions have bought stocks. This marks a very significant shift in both the extent and urgency of action. Although China's domestic equity indices fell on Friday, they have been better behaved than the US indices recently, and that may well continue.

It felt risky out there last week, but returning to our table of risk earlier, perhaps the risks are not worsening. This does not mean an end to the current market volatility, but it tells us that beyond all the identified risks there are also solid opportunities likely to underpin and advance markets further down the road.

Hawkish Fed hovers over markets

Thanks in no small part to the Fed, last week was another wild ride in capital markets. Monday was panicky, amid global liquidity fears, increased geopolitical risks and slowing global growth – forcing a sharp sell-off in US stocks and then a strong recovery before the closing bell. Market volatility continued over the following days, culminating in a dramatic drop on Wednesday afternoon, after Jay Powell used the Fed's post-meeting press conference to broadcast his most hawkish message in years.



Powell all but confirmed the Fed would raise interest rates in March, and did not rule out a more aggressive tightening schedule than markets were expecting already for this year. Three quarter-percentage point hikes are pencilled in for this year, but the FOMC is open to more if needed. Powell even suggested this could start with a 0.5% hike in March, noting that labour market conditions are tight and inflation is dangerously above target. FOMC members also extensively discussed how to shrink the Fed's $9 trillion balance sheet, laying out a set of principles for starting the process.

Investors were somewhat spooked. The S&P 500 fell nearly 2% during and after the comments, with sellers lining up as Powell was still fielding questions. When the Fed changed its framework back in 2020, investors believed central bank policy would be generally more accommodating and give the economy more of a helping hand, but the pandemic brought about a stress test of unimagined proportions. Consequently, soaring inflation pushed the FOMC into tightening mode faster than most expected, with the committee seemingly keen to restore their credibility over monetary stability and show their resolve to stop inflation from getting out of hand. The FT ran with the headline "No more Mr Nice Guy" after the press conference, noting Powell "would be willing to bring out the hammer to knock prices down."

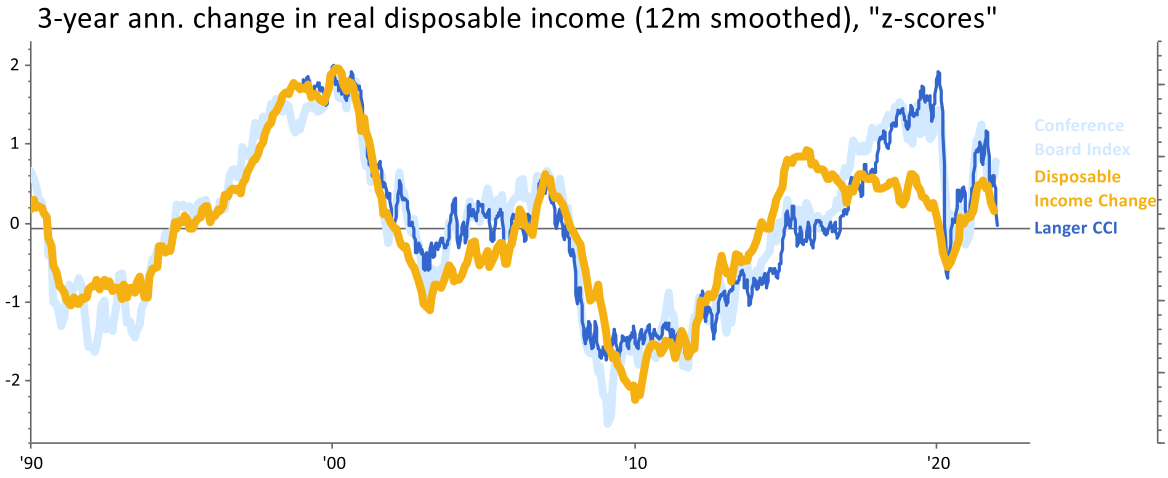
While the Fed's recent change of pace might seem quite astounding, Powell spent most of last year preparing markets for a mild policy tightening. However, as the peak in inflation failed to occur in the summer, the confidence in gradualism disappeared. The FOMC began to worry that the extended period of soaring prices made this shift necessary because of its impact on inflation expectations and decision making. Global supply chain disruptions proved bigger and longer lasting than expected. On Powell's reckoning, supply pressures will remain until 2023. Historically, that's quite a prolonged period of inflation pressure that threatens to embed inflation in economic actors mindsets, putting the fight against inflation top of the agenda.

Officials can take this harsher approach, according to Powell, because of the strength of the US economy. Despite weaker recent signals, growth is still running above trend and the economy is stronger now than when the Fed last started a tightening cycle in 2015. What's more, US unemployment dropped to 3.9% in December, the lowest rate since the pandemic began and consistent with the FOMC's goal of "maximum employment". These factors mean "there's quite a bit of room to raise interest rates without threatening the labour market," according to Powell.

In our opinion, though, that assessment sits uncomfortably with some of the latest data releases. Strong growth, soaring prices and labour market tightness were very visible last year, but as we wrote last week, these factors have all arguably peaked. Although GDP data for the last three months of 2021 proved ostensibly stronger than expected, US final demand growth appears to have eased in the latter stages of the year. Moving into 2022, it seems to have eased further, while supply chain pressures also seem to be easing, according to the Fed's own measures.

The strong growth and high inflation we saw last year was a combination of rebounding demand and constrained supply, compounded by the so-called 'great resignation' of workers not coming back to their jobs post-COVID. However, the most recent indicators of consumer confidence have weakened considerably, which is usually a sign of slower demand ahead.

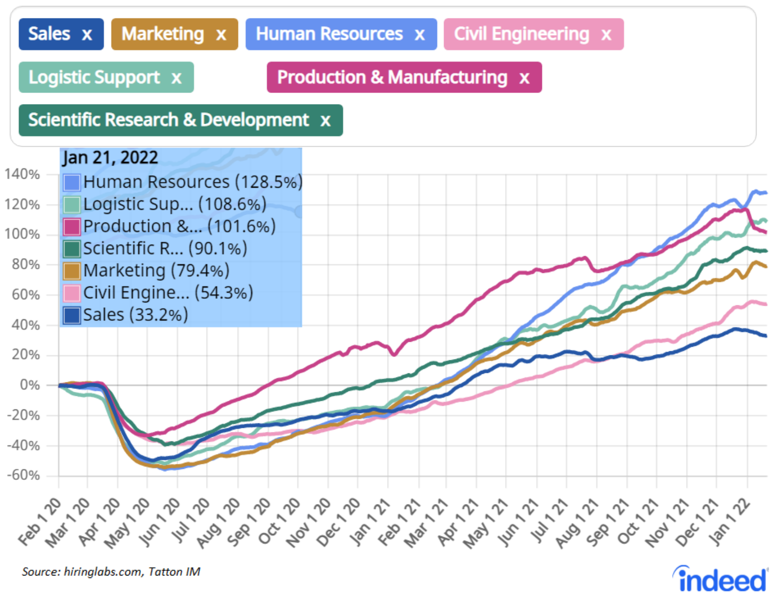
US Consumer Confidence and Income



Source: Factset, Tatton IM, BEA, Conference Board, Langer Associates *29/12/1989 - 28/01/2022*

That is reinforced by the recent move down in real disposable incomes. While last year's labour market tightness pushed up wages (substantially in some sectors, such as haulage), average rises did not keep up with sustained inflation – meaning consumers had less money to spend in real terms. This seems to be ongoing, which, if true, would inevitably dampen demand further down the line.

And now, the boom in job openings may have ended, as the below chart from Hiringlabs (part of indeed.com) shows. It suggests the shortage of workers is no longer as pronounced, reducing wage inflation pressures. The drop-off in job listings is only slight, and could simply be a blip. But when taken together with the other signals – particularly consumer confidence and credit growth – it suggests the labour market is not as tight as the Fed claims. In terms of the wider economy, it also indicates workers feel less able to secure enough pay to protect against inflation pressures.



Source: hiringlabs.com, Tatton IM

Despite the slowdown, growth is still running at a decent pace, which is why the Fed feels it has ample room to tighten. But as TS Lombard research tells us, the problem is that growth is not rooted in an expansion of private credit or so-called 'animal spirits'. Instead, much of the economic support has come from fiscal policy or asset markets themselves (through the balance-sheet effect).

With President Biden's 'Build Back Better' plan having been halted by disagreements within the Democrat Party, fiscal transfers are set to dry up this year, with some analysts pointing to a significant 'fiscal drag' on growth. At the same time, the Fed is bringing down liquidity and thereby removing the support under asset prices. The recent rise in yields and credit spreads has stamped on those areas where credit demand was strong. Alone, none of these factors are a major cause of concern, but together they suggest economic activity is weaker than we thought it would be, and could get weaker still.

For global investors, the main upside is that this appears to be primarily a US problem. For all the talk of energy shortages and bottlenecks in Europe, it is American (and to a lesser extent, British) consumers who have been hit hardest by the disposable income shock. This seems to be down to higher inflation numbers than elsewhere and an abrupt end to fiscal support.

There are many reasons to be positive about growth over the medium term. But there is no doubt that we have seen a significant weakening of the short-term picture recently. In order to stop the slide in consumer confidence spilling over into business confidence, the Fed may have to adjust perceptions of hawkishness sooner rather than later. We were surprised it did not do so after last week's meeting. It is difficult to imagine Powell turning the screw further should data continue to weaken, but then it is also possible that if inflation remains elevated that the Fed may be willing to risk more of a tantrum market upset than allow the inflation genie back out of the bottle. We therefore remain wary of the risks to the US and global economy if it transpires that this is what he does.

China: is looser policy more than just window dressing?

Lenders to the ailing Evergrande Group are understandably eager to hear how the property developer plans to get out of its current mess. They will have to wait a little longer, though. Behind the scenes, restructuring has been going on since before Evergrande's slow motion default at the end of last year – but investors have been kept in the dark. Light was supposed to be shed last week in a call with bondholders. Instead, creditors got 25 minutes of prepared answers and a "please bear with us". Evergrande, the world's most indebted property developer, said it hopes to have a preliminary restructuring proposal ready in six months.

After months (and almost years) of observing the sinking of the great ship, this may come across as disappointing. However, we would point out that restructuring procedures, especially for big entities, always take time. Asset disposals are a very delicate undertaking, as 'fire sales' of relatively illiquid entities can lead to selling prices below their fair value. Stepping back, hearing that a consistent restructuring plan is in the making should be welcome news. As the market cleans up, there will be more space for other property projects to take place (there is still a need for housing, in the right places), and it should also allow the wider Chinese economy to push ahead with its broader development. The focus here would be on reviving depressed consumer confidence, and the announcement of investment in wider infrastructure projects.

In the meantime, Evergrande's shares stood at rock bottom as its survival plans also suffered setbacks. It had apparently planned to use a giant "Versailles-like mansion" in Hong Kong – dubbed "Project Castle" as collateral with creditors. But that idea was quashed on Wednesday after American firm Oaktree Capital, which has security in one of Evergrande's defaulted loans, seized the asset. Evergrande continues to plead for patience, but this was just another setback in a default scandal that investors have dubbed a "slow motion car crash".

International investors want to learn more about the long-term plans for Evergrande. But in fairness, the company's executives probably feel the same way. What happens to Evergrande and its $300 billion pile of debt is entirely down to what government officials in Beijing decide. As one offshore bondholder put it, "the final decision making is led by the government, the company is relatively passive".

Ever since Evergrande began missing debt payments in September, the Chinese government seems to have been operating a controlled demolition. Once a symbol of China's growth and rapidly developing middle class, Evergrande has been allowed to fail by Beijing, provided its woes do not spiral into wider contagion. That is a risky strategy, considering the company's size and the fact that China's property market accounts for a quarter of its economy. But Chinese authorities are reportedly considering a proposal to dismantle the Evergrande group by selling off the bulk of its assets – seemingly in an attempt to draw a line under the crisis.

Beijing's approach to Evergrande is emblematic of its wider economic management. Deleveraging China's sizable private debt load has been a top government priority for years, and officials have pushed ahead with their attempt even when economic growth has been threatened. We saw this throughout the pandemic – while most major economies loosened monetary and fiscal conditions, China tightened policy and cracked down harshly on swathes of the private economy. At the end of last year, Chinese regulators limited the amount banks could lend to property developers.

Tight policy and intermittent crackdowns have had a big impact on growth in the world's second-largest economy. China expanded strongly in the early part of last year's global recovery, but like many other major economies, momentum slowed toward the end of the year. The situation was compounded by Beijing's 'zero-COVID' policy which, despite high vaccination rates, has seen entire regions submit to harsh lockdown measures as the omicron variant spreads.

However, recent weakness seems to have pushed the government to reconsider its policy. The People's Bank of China (PBoC) has cut interest rates and bank reserve requirements in a bid to stimulate demand. Recently, it pledged to open its monetary toolbox and use its lesser-known tools to boost credit expansion. This is despite its global peers moving in the other direction. Promptly, after disappointment at the beginning of the year, China's USD HY declined from its renewed high in January.

Curiously, this leaves us in a reverse of the situation earlier in the pandemic. As the Fed tightens US monetary policy, China is moving the other way. While this is unlikely to result in an all-guns-blazing approach, it should cushion China's current slowdown and maintain the economy's impressive (in absolute terms) growth rate.

This dispersion in policy would not have been possible a decade ago. But gradual reforms have resulted in a freer float of the renminbi (RMB), allowing the PBoC to loosen conditions on its own terms. That should boost lending, lower borrowing costs for companies and see the RMB move lower against the US dollar. As well as delivering a boost for Chinese exporters, it could also help alleviate global inflation pressures.

On that point, it is worth noting China has experienced significantly less inflation pressure than elsewhere, while still benefitting from last year's broad global rebound. Chinese consumers have therefore not had the same hit to real disposable incomes as those in the west, meaning the starting point for demand is healthier. At the same time, two years of strict COVID policies and a crumbling housing market have undermined the mood of households. Cleaning up the housing market (which will take at least another year) and managing the economic fallout (e.g., where will construction workers go?) should be a process which allows opening up household balance sheets for economic activity.

These factors have turned many major investment banks positive on Chinese equities this year. This is perhaps a controversial play, considering the backdrop of weakening growth, property sector woes and a government fond of crackdowns. There is also a strong possibility that Beijing could reverse its stance if debt fears continue, and some have suggested its policy changes are just economic window dressing ahead of the upcoming Winter Olympics.

We think the move toward stimulus is genuine, even if it is going to be the 'new' Chinese way of doing things – all in moderation. Cleaning up an entire sector will see its losers and winners, but is a necessity. At the same time, those who dare stand the most to gain if they buy before the dawn, when the picture still looks dark. The recent news on Evergrande suggests officials want to put these problems behind them. And while Beijing has dragged its feet on the stimulus front, there are positive signs on the horizon.

Global Equity Markets

Market	Fri 15:54	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7439	-0.7	-55	⬀	⬀
FTSE 250	21651	-2.8	-612	⬊	→
FTSE AS	4171	-1.1	-46	→	⬀
FTSE Small	7115	-2.0	-144	⬂	→
CAC	6916	-2.2	-153	→	⬈
DAX	15244	-2.3	-360	⬂	→
Dow	34088	-0.5	-178	⬊	→
S&P 500	4330	-1.5	-68	⬊	⬀
Nasdaq	13453	-2.3	-316	⬊	→
Nikkei	26717	-2.9	-805	⬊	⬊
MSCI World	2955	-2.3	-70	⬊	→
CSI 300	4564	-4.5	-216	⬂	⬊
MSCI EM	1192	-4.2	-52	⬂	⬊

Top 5 Gainers

Company	%
Vodafone	+8.3
J Sainsbury	+5.0
Tesco	+4.8
HSBC	+4.5
Royal Dutch Shell	+4.4

Top 5 Decliners

Company	%
Fresnillo	-23.8
Polymetal International	-14.6
Just Eat Takeaway.com N	-13.5
Sage	-10.7
Barratt Devts	-10.6

Currencies

Pair	last	%1W
USD/GBP	1.341	-1.1
GBP/EUR	0.832	+0.6
USD/EUR	1.12	-1.6
JPY/USD	115.16	-1.3
CNY/USD	6.36	-0.4
Bitcoin/$	37,156	+5.1

Commodities

Cmdty	last	%1W
Oil	90.79	+3.3
Gold	1784.0	-2.8
Silver	22.34	-8.1
Copper	432.5	-4.4
Aluminium	3098.5	-0.4
Soft Cmdties	226.7	-2.7

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	15.5	12.1	14.2
FTSE 250	2.6	14.1	15.7	16.2
FTSE AS	3.6	15.2	12.5	14.4
FTSE Small x Inv_Tsts	2.3	11.1	13.5	15.7
CAC	2.2	19.8	14.2	15.1
DAX	2.2	14.2	13.6	13.7
Dow	1.9	17.5	18.1	16.7
S&P 500	1.4	22.4	19.6	17.9
Nasdaq	0.7	25.4	27.4	23.5
Nikkei	1.8	14.3	16.3	17.8
MSCI World	1.8	19.3	17.8	16.9
CSI 300	1.8	15.6	13.5	12.6
MSCI EM	2.5	12.1	12.1	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.24	+0.07
UK 15-Yr	1.39	+0.06
US 10-Yr	1.78	+0.03
French 10-Yr	0.37	+0.04
German 10-Yr	-0.04	+0.02
Japanese 10-Yr	0.17	+0.03

UK Mortgage Rates

Mortgage Rates	Jan	Dec
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.56	1.53
3-yr Fixed Rate	1.53	1.52
5-yr Fixed Rate	1.59	1.54
10-yr Fixed Rate	2.55	2.56
Standard Variable	3.63	3.62

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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